

**Abstract:** Many private business owners elect to incorporate, turning their companies into C corporations. But, at some point, they may consider converting their businesses into S corporations. This article reviews some of the important considerations associated with this decision. A sidebar looks at the requirements for converting to S status in the first place.

## **Should you convert from a C corporation to an S corporation?**

Many private business owners elect to incorporate, turning their companies into C corporations. But, at some point, you may consider converting to an S corporation. This isn't necessarily a bad idea, but it's important to know the ramifications involved.

### **Similarities and differences**

S and C corporations use many of the same recordkeeping practices. Both types of entities maintain books, records and bank accounts separate from those of their owners. They also follow state rules regarding annual directors meetings, fees and administrative filings. And both must pay and withhold payroll taxes for working owners who are active in the business.

There are, however, a few important distinctions. First, S corporations don't incur corporate-level tax, so they don't report federal (and possibly state) income tax expenses on their income statements. Also, S corporations generally don't report prepaid income taxes, income taxes payable, or deferred income tax assets and liabilities on their balance sheets.

As an S corporation owner, you'd pay tax at the personal level on your share of the corporation's income and gains. The combined personal tax obligations of S corporation owners can be significant at higher income levels.

### **Dividends vs. distributions**

Other financial reporting differences between a C corporation and S corporation are more subtle. For instance, when C corporations pay dividends, they're taxed twice: They pay tax at the corporate level when the company files its annual tax return, and the individual owners pay again when dividends and liquidation proceeds are taxed at the personal level.

When S corporations pay distributions — the name for dividends paid by S corporations — the payout generally isn't subject to personal-level tax as long as the shares have positive tax "basis." (S corporation basis is typically a function of capital contributions, earnings and distributions.)

### **Risk of tax audits**

C corporations may be tempted to pay owners deductible above-market salaries to get cash out of the business and avoid the double taxation that comes with dividends. Conversely, S corporation owners may try to maximize tax-free distributions and pay owners below-market salaries to minimize payroll taxes.

The IRS is on the lookout for both scenarios. Corporations that compensate owners too much or too little may find themselves under audit. Regardless of entity type, an owner's compensation should always be commensurate with his or her skills, experience and business involvement.

### **The right decision**

For businesses that qualify (see sidebar), an S corporation conversion may be a wise move. But, as noted, there are rules and risks to consider. Also, as of this writing, there are tax reform proposals under consideration in Washington that could affect the impact of a conversion. Our firm can help you make the right decision.

### **Sidebar: Which companies can elect S status?**

Not every private business is eligible to be an S corporation. In order to elect S status, a company must:

- Be a domestic corporation,
- Have only allowable shareholders (individuals, certain trusts and estates, but not partnerships, corporations or nonresident alien shareholders),
- Have no more than 100 shareholders,
- Have only one class of stock, and
- Not be an ineligible corporation, including certain financial institutions, insurance companies, and domestic international sales corporations.

All shareholders must consent to the S election by signing Form 2553, "Election by a Small Business Corporation."